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COMMERCE FOR MSELIGMAN AND WBASTIAN
STATE PASS USTR FOR AMALITO

E.O. 12958: DECL: 02/02/2017
TAGS: EPET ENRG PREL BBSR NI VE HO
SUBJECT: HONDURAN PRESIDENT ZELAYA SAYS HE BACKS FUEL
SECTOR LIBERALIZATION, BUT TIME IS RUNNING OUT

REF: A) TEGU 0170 AND PREVIOUS

Classified By: AMB Charles Ford for reasons 1.4 (b,d)

¶1. (C/NF) Summary: President Zelaya says he wants a market-based fuel sector reform, but the GOH must reach a deal with the international oil companies (IOCs) before domestic pressures force him to move back towards a national import scheme. A recent deal in principle with Honduran fuel storage owner DIPPSA provides a needed piece for sector liberalization, but it could also be used as a next step towards a national import scheme. A recent visit by Conoco representatives underscored that the pressure is still on from some quarters to adopt a state-run fuel import monopoly. President Zelaya has gotten about as much political and economic benefit from that proposal as he is likely to get. Any more steps he takes towards a state takeover of the sector would only erode those gains, and expose Honduras to lawsuits and loss of investor confidence. Post therefore finds Zelaya's professed support for market opening credible, since it is now in his political self-interest to engineer a GOH exit out of the nationalization scheme. His challenge will be to craft an exit strategy that preserves his gains but also convinces the public that liberalization is the appropriate next step in the GOH's cost-cutting plan. Zelaya's rhetoric has begun to lay the groundwork for this delicate maneuver, but GOH actions have yet to catch up. The GOH needs to close this deal soon, perhaps during upcoming talks with the IOCs on February 5 and 6. Failing that, the GOH will engage in talks with U.S. firm ConocoPhillips by February 9 as a potential monopoly supplier to a GOH-run national import scheme. Post and the private sector remain constructively engaged in supporting a policy of liberalization. The questions now facing Post and the IOCs are whether Zelaya will keep faith with his new-found market orthodoxy, and whether he has the ability to deliver on his promise. End Summary.

¶2. (C/NF) Since January 25, President Jose Manuel "Mel" Zelaya Rosales has made several public comments preparing the ground for a GOH pivot out of the current state-run import proposal and into a move towards a liberalized market. On

distinct occasions he has called for liberalization of the market, praised the competitive fuels markets that exist in El Salvador and Guatemala, and warned Hondurans against getting "tied to just one company." On February 1, for the first time Zelaya told the public that if Honduras were to sign ("aunque firmemos") with ConocoPhillips as a sole source supplier, there would be no further price reductions for gasoline as a result of the scheme. Presidential advisor Arturo Corrales has for several weeks publicly said that any savings would come from changes to the GOH pricing formula and not from savings on imports, but this was the first time Zelaya himself has said this to the public. Minister Enrique Flores Lanza told EconChief that this tactic had slowly opened a political space in which Zelaya now feels he can move towards liberalization.

¶3. (C/NF) Zelaya has also repeatedly told Ambassador and others privately that he now supports fuel sector liberalization, and seeks an exit from this crisis that includes the IOCs currently operating in Honduras. It was on Zelaya's personal instructions that Corrales first engaged with the IOCs in November 2006, and it was Zelaya's decision to dispatch Corrales and Minister Flores Lanza to El Salvador on January 18 with orders to seek a genuine accommodation with the IOCs. Given his penchant for ad-libbing during his public remarks, Zelaya was almost certainly also the author of his recent rhetorical shift away from any mention of the fuel import solicitation. Publicly and privately, Zelaya has clearly adopted a market-based approach to the fuels issue. The questions now facing Post and the IOCs are whether Zelaya will keep faith with his new-found market orthodoxy, and whether he has the ability to deliver on his promise. In private discussions, the GOH seems increasingly anxious to

conclude a deal with the IOCs. A ConocoPhillips delegation returns to Honduras on/about February 8 to sign the exclusive contract it won under the previous plan to nationalize imports. The GOH feels it must reach a market-based deal with the IOCs by then, or it might not be able to withstand domestic political pressures to move ahead with the state-run import scheme and sign with Conoco.

¶4. (C/NF) In the meantime, the GOH has been locked in a contest of wills with Honduran fuels importer/distributor DIPPSA over using DIPPSA storage facilities. Under DIPPSA's contract with the GOH, DIPPSA is required to allow the GOH to use the facilities if needed during an emergency, for which DIPPSA will be paid a fair price. The GOH calculated that a fair price, based on industry standards, would be USD 0.015 to 0.022 per gallon of throughput. The GOH padded this figure generously and offered DIPPSA USD 0.03; DIPPSA demanded 0.065. Unwilling to pay such a high fee, the GOH noted that DIPPSA was contractually obligated to accept a fair offer, and threatened to take DIPPSA to court over this violation of the contract. In the end DIPPSA blinked, and initial reports indicate that the GOH and DIPPSA have settled on a price of 0.037 per gallon. Setting this price is a key component of reforming the port fees portion of the fuels pricing formula (which the GOH seeks to reduce from USD 0.112 per gallon to approximately 0.06). The international oil companies (IOCs) cautiously support this effort as a means to reduce price distortions in the state-run pricing formula and to deliver cost savings to the Honduran consumer. This and other fee reductions have been the tent-pole of IOC/GOH talks since the breakthrough January 18 meetings in El Salvador.

¶5. (C/NF) Confusing to the IOCs, however, was a simultaneous public exchange of letters between the GOH and ConocoPhillips, in which Conoco said that once the storage issue is resolved, the firm would enter into an exclusive delivery contract with Honduras. The pressure to negotiate a deal with DIPPSA was therefore also in the interest of those who oppose liberalization and instead want to see state control over the sector and a sole-source contract signed with Conoco. As a result, both the pro-liberalization and

pro-nationalization forces see the DIPPSA deal as a victory for their cause. President Zelaya claims he pursued a deal with DIPPSA as part of putting the pieces in place for fuel sector liberalization. Many others, however, continue to push for the nationalization of the sector and see this same agreement with DIPPSA as an important step along that path.

¶6. (C/NF) Further clouding the issue was the surprise lightning visit on February 1 by a senior representative for Conoco. Following closed-door meetings with Minister Enrique Flores Lanza in which the DIPPSA deal was presumably presented to Conoco, the representative held a press conference in which he announced that "We don't want to be involved in any expropriation or nationalization. Those are words we don't like." He went on to say, though, that once the GOH has guarantees of terminal availability, Conoco would sign a contract to supply the GOH with fuel. In an email following his visit, the Conoco representative told EconChief that "things are proceeding quite well now. Conoco should be signing (an exclusive import contract with the GOH) next week." The contract with DIPPSA, once signed, therefore also benefits Conoco in its quest to secure exclusive rights to supply fuel to the GOH.

¶7. (C/NF) These recent positive developments are in keeping with Zelaya's public and private assurances, but they do not irrevocably commit the GOH to a path of market liberalization. Reaching a deal with DIPPSA does not close the door to a GOH takeover of the sector, should Zelaya fail. The IOCs are impatient with the GOH's political posturing, but most continue to bargain in good faith. In a telcon with Ambassador, senior executives of Esso (ExxonMobil) expressed their frustration with the lack of clarity in the process and the poor communication from the GOH on developments.

Ambassador explained that this issue has much political baggage in Honduras, particularly for President Zelaya. It is taking a significant amount of effort by Zelaya to convince the public that a GOH shift away from the announced nationalization of imports and towards liberalization is the right move. Zelaya says he has reconciled himself to this course of action, but he must now get Honduran public opinion on-board, and that will take time. Ambassador urged the companies to continue to support this effort, recognizing the political risks Zelaya is running and the public and private maneuvering that might be required. The IOCs met Flores Lanza, Corrales, and Minister of the Presidency Yani Rosenthal on February 2 to continue talks. Esso delivered "a hard message" emphasizing its support for the reform process but also the urgency of moving quickly on it, given continuing losses that the companies face. The GOH presented the IOCs with a pricing formula reform proposal, and requested feedback by February 5.

¶8. (C/NF) Comment: Regardless of whether Zelaya can deliver liberalization of the fuels sector or opts to pursue state-run importation, setting a reasonable price with DIPPSA for storage was a necessary step. Conclusion of those talks was something of a step forward. Post is optimistic that Flores Lanza's public comments about that deal clearing the way to create a government administered import regime are intended to keep pressure on the IOCs to bring their best offers to the table as soon as possible. Zelaya has realized, and is trying to communicate to the public, that the savings from any state-run sole-source contract would be slight. It appears he also understands that the legal and political damage from pursuing a nationalization scheme could be significant. Therefore, he faces the choice of either pocketing the political benefits and price cuts he's already obtained and moving on to liberalization, or of pursuing a national import plan, poisoning investor relations, and exposing Honduras to multiple lawsuits, all with little likelihood of additional cost savings. Since Zelaya is both a populist and a political pragmatist, we expect he will take his winnings and move on, rather than pick a fight that he

will ultimately lose even if he wins. We don't discount the chance that certain other players will take one more run at the nationalization scheme. But, if Zelaya can withstand those pressures, we think his political instincts might work to our advantage in finally moving Honduras towards a competitive fuels market. End Comment.

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